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Serving Investors, Public Company Auditors & the Markets

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WRITTEN TESTIMONY OF

Cynthia Fornelli
Executive Director
Center for Audit Quality

BEFORE THE

ADVISORY COMMITTEE ON THE AUDITING PROFESSION UNITED STATES DEPARTMENT OF THE TREASURY

February 4, 2008

Chairman Levitt, Chairman Nicolaisen, members of the Committee, Treasury staff and observers, good afternoon and thank you for the opportunity to testify on behalf of the Center for Audit Quality.

As the Center's executive director, I am honored to provide my views on your effort to improve audit quality and ensure the viability and resilience of the public company auditing profession. You and the other members of the Advisory Committee on the Auditing Profession have an important, timely opportunity to lead significant improvements to the integrity of information used by investors in the U.S. capital markets. Our nation's economic well-being depends on investors' confidence that the information they receive about complex business transactions in a global economy continues to be the gold standard for the rest of the world. Public company auditors have a central role in helping to safeguard the integrity of our markets.

The Center for Audit Quality was established last year to encourage an open discussion of ways to improve audit quality. Our members are U.S. public company auditing firms that are registered with the Public Company Accounting Oversight Board (PCAOB). We have approximately 800 members and are led by a governing board that includes leaders from eight public company audit firms, the American Institute of Certified Public Accountants (AICPA) and three public board members who represent perspectives from the investor, issuer, regulatory and academic communities.

The Center welcomed the creation of this Advisory Committee, and we are eager to provide our perspective. Public company audit firms have worked diligently to enhance investor confidence in the markets and to improve the audit process. Continuing to bolster investor confidence, improve audit quality and keep pace with the rapid changes in the business and financial worlds is clearly in the best interests of the Center's members, issuers, investors and the markets.

My testimony today will focus on six areas that deserve the critical attention of this Committee — human capital, professional judgment, auditor independence, sustainability, fraud detection and transparency — but I am prepared to address questions on other topics related to public company auditing.

I should point out that this testimony represents the observations of the Center for Audit Quality, but not the views of any specific firm or individual, including the two members of the CAQ's governing board appointed to serve on the Advisory Committee: KPMG International Chairman Tim Flynn, who also serves as chairman and chief executive of KPMG in the United States, and AICPA President and CEO Barry Melancon.

Human Capital

Quality audits begin with well-trained auditors. Therefore, it is essential that we have an adequate supply of talented professionals to meet the growing needs of investors and the challenges of public company audits. While the number of accounting degrees awarded by the nation's colleges and universities is on the upswing — rising 20 percent since the 2001-2002 academic year — a significant number of graduates are choosing careers other than public company auditing.

But the issue is more complex than the number of student graduates. The audit firms need more than just a supply of accounting graduates. They need intelligent, well-educated individuals with the experience to deal with increasingly complex transactions and a growing variety of financial instruments. Just as important as numbers and quality, we need to bring more diversity to the profession to keep pace with the changing nature of society, the workforce and public companies themselves.

As this Committee heard at your December 3 public meeting, America's universities and colleges simply do not have enough Ph.D.-level faculty to educate the next generation of auditors. Because of the profession's concern over the shortage of qualified faculty to teach accounting, the AICPA Foundation, along with the 80 largest CPA firms, are working to raise more than \$17 million to fund additional Ph.D. candidates at participating universities. While such private sector efforts will not solve the problems you have heard about, they are a start that demonstrates the commitment of the audit firms to fund long-term, sustainable solutions.

Audit firms should also help foster a closer relationship between the profession and academia. Audit firm leaders recognize their responsibility to be more open in sharing practice experience with students and professors. Faculty should be encouraged to take sabbaticals to spend time at firms. Internship and fellowship opportunities for faculty at audit firms should be expanded. Such fellowships should be structured to give faculty opportunities to conduct research that will count toward promotion and tenure.



In addition, the Advisory Committee should:

- Consider alternatives to traditional classroom instruction to satisfy the 150-hour rule. A possible addition for some students could be experiential learning, in the form of practicums or internships within firms, as long as they are structured to satisfy the spirit of post-secondary or graduate content.
- Increase the number of H1-B visas to expand the pool and enhance global/trans-national capability of audit teams.
- Dedicate funds and people to work with accounting professors to ensure that the curriculum is keeping pace with developments in business transactions, international economics and financial reporting. Areas of specific attention include the persistent need to impart high ethical standards and the evolving need for instruction on international accounting and auditing standards. Education and training to prepare current and future auditors for any transition to international accounting and auditing standards is important to the stability of our markets.
- Encourage accreditation bodies to revise accreditation standards to allow the employment of more audit professionals, either active or retired, as adjunct professors.

Professional Judgment

We are pleased that the Securities and Exchange Commission's (SEC) Advisory Committee on Improvements to Financial Reporting is moving toward a professional judgment framework. I urge this Committee to support that effort.

U.S. GAAP — a standard that has served us well — already requires the exercise of professional judgment, and any movement toward principles-based accounting, such as IFRS, will require even greater reliance on professional judgment. As reflected in PCAOB Auditing Standard No. 5, auditing standards also appear to be headed toward the use of greater professional judgment.

It seems clear that we are beginning down a path where we will find fewer detailed rules and more judgment being exercised by preparers and auditors of financial statements and assertions regarding internal control over financial reporting. As we move forward, everyone in the financial reporting process (not only managers and auditors but also standard setters, regulators and courts) should have a common understanding (1) of the process that should take place when professional standards or guidance refer to the exercise of professional judgment, (2) that a rigorous judgment process may lead two competent, knowledgeable CPAs to come to differing, yet equally reasonable, solutions to an issue, and (3) that the ultimate goal of the exercise of such judgment is to provide full and fair disclosure to investors.

A well-crafted professional judgment rule would benefit investors, auditors and issuers. By adopting such a rule, the SEC would formally recognize the essential role of good-faith professional judgment in the financial reporting and audit processes.



A professional judgment rule could reduce confusion arising from a large volume of restatements by resulting in fewer restatements, particularly those that result from different judgments and do not seem to be of significance to investors, and enhance financial reporting and audit quality by requiring issuers and auditors to explain the reasoning behind a judgment-based decision. If a competent accountant acts in good faith, has a goal of providing material information to investors, follows a rigorous judgment process that includes adequate contemporaneous documentation, and reaches a reasonable answer that is allowable under existing standards, then we believe regulators and other reviewers should give the accountant the benefit of any doubts.

Allowing preparers and auditors to exercise professional judgment with confidence would benefit all stakeholders in the capital markets. However, a professional judgment rule can only work if preparers and auditors trust that well-reasoned, good-faith judgments will be evaluated in an environment of professional respect.

The professional judgment rule should be carefully crafted to reflect real-world audit experiences and be clear enough to avoid the need for interpretation. The rule should take into account the fact that the judgments made during the financial reporting and audit processes can only reflect the information available at the time, not information that becomes available after the audit is concluded. If done properly, a professional judgment rule will benefit all stakeholders by providing an environment where investors know that preparers, auditors and regulators act in good faith, follow applicable standards and have rational bases for their decisions.

Auditor Independence

Public company auditors are acutely aware of the necessity of conducting their work impartially and with a healthy dose of professional skepticism. The Center fully supports efforts by Congress and federal regulators to protect investors and maintain the integrity of our capital markets through ongoing efforts to support auditor independence as changes occur. We will not make, nor would we support, any recommendations to this Committee that would retreat from those goals.

After several years of experience operating with the SEC's auditor independence rules, which were significantly modified in 2000 and amended after passage of the Sarbanes-Oxley Act, it is time to review some of those rules. The goal should be to ensure that each provision enhances auditor independence, without unintended negative impacts that outweigh the benefits. Appropriate adjustments to the independence restrictions could lead to greater choice for public companies in choosing auditors — without weakening the protections that help public company auditors remain independent while supporting the interests of investors and the capital markets.

The Center urges the Advisory Committee to consider:

- A regulatory process for audit firms to remediate independence breaches that would be immaterial to reasonable investors when such breaches are discovered. For example, investors may not be concerned if an accounting firm inadvertently handles payroll for a small sales outpost of a global corporation and ceases that activity after the audit team becomes aware of it. Of course, materiality considerations should only apply to services that could not reasonably be construed as significant to the audit.



- Reconsidering the definition of “audit client” and “affiliate” to clearly target those relationships that could cause a conflict for auditors. The current definitions may be overly inclusive. The resulting web of relationships for some company audits may not have any real influence on the auditor’s ability to conduct a fair and impartial audit in the eyes of a reasonable investor.
- Harmonizing independence rules to establish a single, clear and effective standard. The ultimate goal should be an international standard, but a good place to start is to draw upon the best of rules covering auditor independence at the SEC, PCAOB, Department of Labor, IFAC, AICPA and various state regulatory bodies.

Sustainability

The rule of law is critical to the integrity of our capital markets. Our legal system is the ultimate arbiter for all market stakeholders, and is the mechanism for remedying fraudulent behavior and other wrongdoing. It is vitally important that the system treats all stakeholders fairly.

However, the legal structure in the United States is complex and puts unique pressures on many industries and professions, including public company auditing. One aspect of our legal system that many believe warrants review is Section 10(b) of the Securities Exchange Act of 1934. Other profession representatives will address this more specifically in their testimony, and we urge you to give their thoughts due consideration.

Another aspect of our current legal structure that should be considered is the cost of litigation. Litigation increases the cost of doing business in the United States — a cost that investors ultimately bear. As it relates to public company audits, litigation can exacerbate concentration. For audit firms that may be contemplating moving into the public company auditing space, the increased risk of litigation associated with auditing public companies can be a barrier to entry. Moreover, a catastrophic lawsuit could result in the demise of an audit firm with subsequent impact throughout the profession, significantly altering the competitive landscape for audit work among large corporations with negative repercussions for investors and the capital markets.

A topic that was discussed during the Advisory Committee’s last hearing relates to liability caps. Others testifying today will address the merits of their differing perspectives on this issue. For its part, the CAQ supports the continued discussion of the concept of a liability cap, recognizing the difficulty of formulating a proposal that meets the goals of equity among different sized audit firms and advancing the overall interests of investors and the capital markets.

While the discussion about liability caps needs to continue, there are some lesser reforms that could maintain accountability and improve the legal process. One idea is to change federal and state rules for appeal bonds to ensure that defendants can obtain appellate review of large judgments without bankrupting a company or firm in the process by requiring them to post a bond equal to or in excess of large judgments. As one of the bedrock protections in our legal system, the ability to appeal should not be rendered meaningless by unlimited appeal bond requirements.

Another incremental approach would be to give defendants in a private lawsuit in federal district court the right to appeal a denial of a motion to dismiss. The inability to appeal means that



defendants often must choose between expensive litigation or a potentially costly settlement of a lawsuit that it believes is without merit. Defendants should have the opportunity to face that choice only after they have exhausted efforts to have the suit dismissed.

Finally, it would be helpful to consider changes that would clarify the ability of audit firms to utilize the captive insurance company rules. Under current U.S. law, captive insurers wholly owned by a single U.S. accounting firms are required to cover risks of unrelated parties. If the accounting firm is not viewed as covering unrelated risks, then it and its captive can not utilize the tax rules applicable to insurance companies.

Fraud Detection

Reliable financial information is critical to the capital markets. As one of its first major initiatives, the CAQ last year launched a national Public Dialogue Tour to learn from a variety of stakeholder groups what should be done to improve the quality, relevance and integrity of financial reporting. The Center is visiting a variety of cities across the country to hear directly from users of audited financial information and better learn how business reporting can evolve to meet the needs of all types of investors.

In seven events thus far, there has been widespread agreement among issuers, state and federal officials, scholars, legislators and investors that auditors are a valuable — even vital — ally for investors. During these public dialogues, investors have made it abundantly clear that they expect auditors to find material fraud.

Enhanced fraud detection is a high priority for the profession. Public company auditors acknowledge that the risk of financial reporting fraud is an ongoing and serious threat to the stability of the capital markets, and the profession is committed to an effort to work with other responsible parties to seek new and better methods to reduce the threat.

Detecting and preventing fraud requires a collaborative effort by business leaders and auditors. Each plays an important role in the shared goal of combating financial reporting fraud. Business leaders have a responsibility to foster an ethical culture and set the tone at the top, and strengthen their internal control design and implementation. For their part, auditors should continue to develop and employ improved techniques to identify material frauds.

Transparency

Finally, I would like to make a point with regard to increased transparency of the profession. In our view, this is a topic best addressed through a robust administrative process that encourages public comment and results in either rulemaking or legislation. This approach will help ensure that any disclosure regime does not have the unintended consequences of dissuading firms from taking on public company audit work or exiting the public company audit market due to resultant competitive disadvantages, thereby exacerbating the concerns with concentration and audit firm choice.



Conclusion

In conclusion, the nation's public company auditors share your commitment to a profession that is strong, vibrant and committed to quality. Your consideration of the recommendations outlined in my and others' testimony will go a long way toward the enhancement of the public company auditing profession and audit quality — audit quality that is made possible by a workforce of sufficient size, skills and training; whose independence is beyond question; whose professional judgment is respected; and whose firms have the necessary financial flexibility to serve the needs of investors and issuers alike.

I appreciate the opportunity to represent the Center for Audit Quality before this distinguished Committee, and I want to repeat my offer to help in any way we can. I wish you all the best in your important work.



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